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Monday, May 01, 2006

Security and the burden of lawsuit

The need to sue can be an expensive burden. A plaintiff often needs to go through a very long and expensive legal process, the results of which may be little or nothing due to the insolvency of the party sued.

Because of this problem, large chunks of commercial law and practice -- and especially the areas of mortgages involving real property, secured transactions involving goods, and negotiable instruments -- deal with allocating the burden of lawsuit. Generally, the burden of lawsuit over a transaction should be shifted to the partie(s) who are more likely to breach the legal obligations created by the transaction, or more likely to become insolvent, or both.

Creditors often use collateral to shift the burden of lawsuit to debtors. Instead of having to sue to get their money, creditors simply repossess the collateral, shifting the burden of lawsuit to the debtor. Creditors sometimes also use a surety (e.g. a co-signer) to reduce the burden of lawsuit by adding a target who is more solvent.

Another way creditors shift at most of the burden of lawsuit is by having the debtor sign a promissory note. The creditor can then sell the note to a third party who is entitled to collect the note as a holder in due course, free of most defenses to payment on the original contract. Freedom from most defenses (such as fraud, failure to perform, etc.) to the original transaction makes the debt owed by the debtor to the holder in due course very clear-cut, thus greatly lowering the burden of lawsuit for the new creditor. The original creditor benefited because it could sell this unburdened debt at a higher price than a debt burdened by legal problems with the original transaction. If the original creditor breached a contract with the debtor (for example by failing to deliver promised goods), the burden of lawsuit is now on the debtor to sue the original creditor: the debtor must pay the note regardless. (In the United States, there are some recent consumer protection exceptions to this general rule). If the debtor fails to pay the note, this is a very straightforward lawsuit compared to the usual breach of contract, and thus likely to be settled at little cost. Thus, the promissory note has shifted most of the burden of lawsuit from the creditor to the debtor.

At a more basic level, the burden of lawsuit is shifted by shifting actual control as well as legal possession over objects of value. "Possession is 9/10 of the law." To this end, security technology and in particular smart contracts will likely become very useful devices for shifting the burden of lawsuit in commercial transactions.

Posted by Nick Szabo at 1:46 PM

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Nick Szabo

"A premier thinker about history, law and economics, and the lessons they have for security." -- Adam Shostack, Emergent Chaos

"Szabo comes out with these essays that leave me in awe." -- Brian Dunbar

"Reading material that is eclectic, challenging and endlessly fascinating." -- Sean McGrath, Propylon

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